

Internal Revenue Service
memorandum

CC:TL-N-6988-91

Br:LSMannix

date: AUG 16 1991

to: Eugene H. Ciranni,
Special Trial Attorney

W:SF

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [REDACTED]

This responds to your request for Tax Litigation advice, dated May 16, 1991. It is our understanding that this case is [REDACTED].

ISSUES

1. Whether [REDACTED] may recognize losses on its disposition of debentures issued by its sister corporation, [REDACTED], where such debentures were dropped down to [REDACTED] from their common parent, [REDACTED], after the conversion of the debentures into [REDACTED] common stock.

2. Whether [REDACTED] realized discharge of indebtedness income upon the transfer of the debt from its sister corporation, [REDACTED], to their common parent, [REDACTED], and then dropped down from [REDACTED] to [REDACTED].

CONCLUSIONS

1. [REDACTED] may not recognize losses on the disposition of the debentures.

2. Assuming that the basis of the indebtedness in the hands of [REDACTED] was at least equal to the remaining amount of the outstanding indebtedness at the time [REDACTED] dropped the indebtedness down to [REDACTED], [REDACTED] did not realize discharge of indebtedness income.

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FACTS

[REDACTED]
(hereinafter referred to as "[REDACTED]"), was incorporated in the Netherlands Antilles on [REDACTED], and was, at all relevant times, a wholly owned subsidiary of [REDACTED] (hereinafter referred to as "[REDACTED]"). [REDACTED] issued two series of Convertible Subordinate Guaranteed Debentures in [REDACTED] and [REDACTED] on the Eurobond market. The [REDACTED] and [REDACTED] debentures had an aggregate face value of \$[REDACTED]. The proceeds of the issuance of the debentures were loaned by [REDACTED] to various subsidiaries of [REDACTED], including \$[REDACTED] of which was loaned to CPC Investment Corporation (hereinafter referred to as "[REDACTED]"). At all relevant times, [REDACTED] was a wholly owned subsidiary of [REDACTED] (hereinafter referred to as "[REDACTED]"), and [REDACTED] was in turn a wholly owned subsidiary of [REDACTED].

[REDACTED] was not an operating corporation and was thinly capitalized. It was created solely for the purpose of issuing the [REDACTED] and [REDACTED] debentures on the Eurobond market and loaning the proceeds back to [REDACTED]'s domestic subsidiaries. The [REDACTED] and [REDACTED] debentures were guaranteed by [REDACTED] and probably could not have been issued by [REDACTED] otherwise.

The [REDACTED] and [REDACTED] debentures were convertible into the stock of [REDACTED]. By [REDACTED], all the debentures had been so converted. [REDACTED] claimed a basis in such debentures (which it claims it received in the conversion transactions) of \$[REDACTED], which was the aggregate fair market value of the [REDACTED] stock issued to the converting debenture holders. According to the petitioners, the indentures under which the debentures had been issued provided that the conversion of the debentures would not result in their cancellation and, accordingly, that all of the debentures remained outstanding in the hands of [REDACTED].

As the debentures were tendered to [REDACTED] for conversion, [REDACTED] contributed them to [REDACTED], which in turn contributed the debentures to [REDACTED]. The petitioners claim that these "drop-downs" qualified as I.R.C. § 351 transactions. By [REDACTED], all the debentures were held by [REDACTED]. According to the petitioners, Properties, and then [REDACTED], succeeded to [REDACTED]'s basis of \$[REDACTED] in the debentures under section 362(a).

On [REDACTED], [REDACTED] redeemed [REDACTED] of the [REDACTED] debentures from [REDACTED] in exchange for \$[REDACTED] cash. The petitioners claim that this portion of the debentures had an aggregate carryover basis in the hands of [REDACTED] of \$[REDACTED] and, therefore, that [REDACTED] realized and

recognized a long-term capital loss in the amount of \$ [REDACTED] in the transaction.

On [REDACTED], [REDACTED] sold another [REDACTED] of the [REDACTED] debentures to [REDACTED] (" [REDACTED] ") for \$ [REDACTED] cash. The petitioners claim that this portion of the debentures had an aggregate carryover basis in the hands of [REDACTED] of \$ [REDACTED]. The petitioners claim that because [REDACTED] incurred an underwriting fee of \$ [REDACTED] on the sale, [REDACTED] realized and recognized a long-term capital loss in the amount of \$ [REDACTED] in the transaction.

On [REDACTED], [REDACTED] sold all of the [REDACTED] debentures to [REDACTED] and [REDACTED] for \$ [REDACTED] in cash. The petitioners claim that this portion of the debentures had an aggregate carryover basis in the hands of [REDACTED] of \$ [REDACTED]. The petitioners claim that because [REDACTED] incurred an underwriting fee of \$ [REDACTED] on the sale, [REDACTED] realized and recognized a long-term capital loss in the amount of \$ [REDACTED] in the transaction.

On [REDACTED], [REDACTED] deposited the remaining [REDACTED] of the [REDACTED] debentures with [REDACTED]. The deposit receipts given by [REDACTED] in exchange for these debentures were issued directly to [REDACTED]'s underwriter, [REDACTED]. [REDACTED] then sold these deposit receipts to the public for \$ [REDACTED] in cash. The petitioners claim that this portion of the debentures had an aggregate carryover basis in the hands of [REDACTED] of \$ [REDACTED]. The petitioners claim that because [REDACTED] incurred an underwriting fee of \$ [REDACTED] on the sale, [REDACTED] realized and recognized a long-term capital loss in the amount of \$ [REDACTED] in the transaction.

On [REDACTED], the board of directors of [REDACTED] declared a dividend to [REDACTED] in the form of the transfer to [REDACTED] of [REDACTED]'s right to receive \$ [REDACTED] of the total proceeds owed to [REDACTED] by [REDACTED]. The \$ [REDACTED] indebtedness was the remaining amount of the indebtedness originally loaned by [REDACTED] to [REDACTED]. As stated in the corporate minutes of [REDACTED] for [REDACTED], the dividend was "in the form of cancellation of \$ [REDACTED] principal amount of receivables held by this company [REDACTED] under the Revolving Loan Agreement between this company and [REDACTED]..." At the time of the alleged dividend, [REDACTED]'s earnings and profits were only \$ [REDACTED]. [REDACTED] reported the dividend on its tax return but then deducted the entire amount under I.R.C. § 245.

[REDACTED] then contributed the \$ [REDACTED] receivable to its wholly owned subsidiary [REDACTED] which, in turn, contributed it to its

wholly owned subsidiary [REDACTED]. [REDACTED] then offset the \$ [REDACTED] contribution against the \$ [REDACTED] payable to [REDACTED] leaving a [REDACTED] balance owed to [REDACTED].

DISCUSSION

I. Issue 1:

A. Substantive View of the Debentures Transactions:

Before discussing the relevant law with respect to the federal income tax treatment of the transactions involving the conversion and subsequent disposition of the [REDACTED] and [REDACTED] debentures, the transactions must be broken down in order to reveal their substance. Only then can the relevant law be applied to determine the federal income tax treatment of the transactions. Similarly, any arguments made to the court in this case should first begin with breaking down the transaction to reveal what actually happened so that the law can be applied. We believe that such law will support a conclusion that [REDACTED] did not realize or recognize any losses upon its disposition of the debentures.

When [REDACTED] issued the convertible debentures at issue, [REDACTED] agreed that it would incur an equity obligation to the debenture holders if the holders ever exercised their conversion rights. The obligation was to exchange [REDACTED] stock for the debentures upon demand by the debenture holders. This obligation cannot be legitimately disputed because the indenture agreements expressly contains the obligation and [REDACTED] was a party to the indenture agreement.

The only reason [REDACTED] would assume such an obligation without receiving a direct and adequate consideration for doing so was because of its relationship to [REDACTED]: i.e., as a parent corporation to its subsidiary. In general, every parent corporation has a financial interest in the financial well being of its subsidiaries because the more successful the subsidiaries, the more successful the parent. In this particular instance, it was in [REDACTED]'s interest to promise to assume this equity obligation in order that its subsidiary, [REDACTED], could obtain the \$ [REDACTED] of financing it received upon the issuance of the debentures. It must be assumed that [REDACTED] would not have been able to obtain the \$ [REDACTED] loan if [REDACTED] did not enter into such an obligation because, otherwise, [REDACTED] would not have been required to assume the obligation.

Furthermore, [REDACTED] realized a tangible, economic gain from [REDACTED]'s promise that it would assume the equity obligation if called upon because, as stated above, presumably [REDACTED] would not have been able to obtain the \$ [REDACTED] loan without [REDACTED]'s

promise to assume the obligation. Because of the relationship between [REDACTED] and [REDACTED], outlined above, the assumption of the equity obligation, when the holder exercises their conversion right, will result in a tangible, economic gain to [REDACTED] and as such should be recognized as constituting a contribution of capital from [REDACTED] to [REDACTED]. This economic reality is the key to the transactions at issue. Put simply, there is no other way to explain the transactions. There is no other way to explain the economic benefit received by [REDACTED] through [REDACTED]'s assumption of the obligation to give the debenture holders [REDACTED] stock for their debentures.

The fact that [REDACTED] was formed solely for the purpose of issuing the [REDACTED] and [REDACTED] debentures on the Eurobond market and loaning the proceeds back to [REDACTED]'s domestic subsidiaries only strengthens the above analysis. Because of this fact, it was clearly in [REDACTED]'s interest to have [REDACTED] obtain the \$[REDACTED] loan because the loan directly benefited it and its subsidiaries. This fact shows that [REDACTED] was making an investment in [REDACTED] that would ultimately reward [REDACTED]. [REDACTED]'s investment in [REDACTED] was to agree to assume the equity obligation so that [REDACTED] could obtain the \$[REDACTED] loan from the debenture holders and reloan the proceeds to [REDACTED]'s subsidiaries.

At the time the debentures were issued by [REDACTED], [REDACTED]'s obligation to the debenture holders was merely contingent and executory and would not become definite until the debenture holders actually demanded conversion of the debentures into [REDACTED] stock. At the time the debentures were issued, the economic benefit to [REDACTED] from [REDACTED]'s promise to assume this equity obligation, if called upon, was still executory and contingent. Consequently, the capital contribution from [REDACTED] to [REDACTED] would not yet have taken place. That is an executory promise to effectively make a capital contribution in the future is at that point not a capital contribution. Furthermore, the full economic benefit contributed by [REDACTED] to [REDACTED] with respect to [REDACTED]'s assumption of the equity obligation would not have been known on the date the debentures were issued. Fortunately, we do not have to measure the amount of the capital contribution from [REDACTED] to [REDACTED] at that time because there is another date on which the economic benefit contributed by [REDACTED] to [REDACTED] can be measured and which, in fact, measures the full amount of the economic benefit contributed by [REDACTED] to [REDACTED].

When the debenture holders demanded conversion, [REDACTED]'s obligation became fixed and, at that time, the full amount of [REDACTED]'s capital contribution to [REDACTED] can be measured. Specifically, upon the conversion of the indentures into [REDACTED] stock, [REDACTED] received the debentures with an aggregate face amount of \$[REDACTED]. Regardless of whether the debentures remained outstanding after the conversion or, in effect, ceased to exist,

received an asset from [redacted] worth \$ [redacted] because at the very least [redacted] could demand the face amount of the debentures from [redacted]. In exchange, [redacted] gave up [redacted] stock with an aggregate fair market value of \$ [redacted]. Thus, the capital contribution made by [redacted] to [redacted] is the difference between the fair market value of the [redacted] stock that [redacted] gave to the debenture holders and the \$ [redacted] worth of indentures it received in exchange: i.e., \$ [redacted].

The \$ [redacted] is the cost to [redacted] of assuming the equity obligation for its subsidiary, [redacted]. And, \$ [redacted] is the economic benefit to [redacted] from [redacted]'s assumption of this equity obligation. As shown above, the only way this can be explained is by the parent-subsidiary relationship between [redacted] and [redacted]. The only way this economic gain can be transferred from [redacted] to [redacted] is by a capital contribution. That is, when the parent does something for its subsidiary; i.e., assumes an obligation for inadequate consideration, it should be recognized as having made a capital contribution to the subsidiary to the extent that the consideration is inadequate.

The consequence of this analysis is that [redacted]'s basis in the debentures is not \$ [redacted] but \$ [redacted]. Because the difference between these two figures was a capital contribution by [redacted] to [redacted], so that such difference should be added to the basis of the debentures received by [redacted]. Accordingly, when the debentures were later dropped down to [redacted] and disposed of, [redacted]'s basis in the debentures would have also been \$ [redacted]. Because the debentures were disposed of by [redacted] for an aggregate amount of \$ [redacted], [redacted] did not realize or recognize any losses upon the disposition of the debentures.

B. Outlined of the Law and its Application to the Facts in this Case:

Our discussion begins with two cases that involved convertible debentures issued by corporations that became subsidiaries of International Telephone & Telegraph Corporation (hereinafter referred to as "ITT"). ITT v. Commissioner, 77 T.C. 60 and 77 T.C. 1367 (1981), aff'd per curiam, 704 F.2d 252 (2d Cir. 1983); ITT v. United States, 90-1 U.S.T.C. ¶ 50,214 and 90-1 U.S.T.C. ¶ 50,297 (S.D. N.Y. 1990). As stated by the United States District Court for the Southern District of New York, the facts are as follows:

...[During the years at issue, ITT] was a multinational corporation and the common parent of an affiliated group of corporations, known as the ITT Group. Among the corporations in the ITT Group...were ITT Avis, ITT Aetna Finance Company ("ITT Aetna"), ITT Continental Baking Co.

("ITT Continental"), and International Standard Electric Corporation ("ISEC"). ITT acquired each of these companies through a variety of assumption and purchase transactions. Each of the above companies, prior to their acquisition by ITT, had issued debentures convertible into shares of that company's stock. At the time of the acquisition, or shortly thereafter, the terms of the debentures were renegotiated so that they were convertible into shares of ITT stock rather than into shares of the now subsidiary companies. ITT did not, however, accept the debt obligations flowing from the debentures, which remained instead with the subsidiary company.

It is these convertible debentures that are now at issue. During the period from 1966 to 1969, ITT accepted a large quantity of these debentures for conversion at a rate that had been set at the time the debentures were renegotiated. Upon receipt of the debenture for conversion, ITT returned the debenture to the applicable subsidiary for redemption. Upon redemption, ITT received either the face value of the debenture in cash from the subsidiary, or counted the face value of the redeemed debenture as an additional capital contribution to that subsidiary. It appears that at the time of conversion, the ITT stock issued to the debenture holder was worth substantially more than the face value of the debenture. Accordingly, the cash ITT received from the subsidiary, or the capital contribution to the subsidiary, was substantially less than the value of the stock delivered by ITT. ITT wishes to deduct as a capital loss the difference between the value of the stock delivered to the debenture holders and the face value of the debentures, subsequently recovered from the subsidiaries in cash or capital contribution equivalents.

ITT, 90-1 U.S.T.C. at p. 83,783. The District Court phrased the issues in that case as follows:

There are three central areas of disagreement between the parties. First, the parties disagree as to whether the debentures continued to be an obligation of the ITT subsidiaries after their conversion into ITT stock. Second, even if the Court finds the debentures to be a continuing obligation of the subsidiaries, the parties disagree as to ITT's basis in the debentures after conversion. Third, the parties disagree as to the preclusive effect of the two 1981 Tax Court opinions, affirmed by the Second Circuit, which addressed issues very similar to the ones now before this Court regarding the 1965 tax year.

Id. It should be noted that the Tax Court case addressed the ITT group's 1965 taxable year and the district court case addressed the group's 1966 through 1969 taxable years.

The district court held that the parties were bound by the previous Tax Court opinions in so far as it was found that ITT's basis in the debentures after their conversion was equal to the fair market value of the ITT stock that ITT gave to the debenture holders in exchange for the debentures. The Tax Court in the earlier ITT case relied on section 1012 and Reg. § 1.1032-1(d) for this holding. See 77 T.C. at 80 n. 23.

In the earlier case, the Tax Court specifically held that the "purchase price" of the debentures upon their transfer from ITT to ITT's subsidiaries was equal to ITT's basis in the debentures, under the authority of Treas. Reg. § 1.1502-41A. Thus, the Tax Court held that ITT (as opposed to the ITT subsidiaries) did not realize or recognize any losses on the transfer of the indentures from ITT to the ITT subsidiaries. However, the Tax Court went on to hold that the ITT subsidiaries (as opposed to ITT) realized and recognized losses upon receipt of the debentures from ITT measured as the difference between the amount the subsidiaries (or their predecessors) received upon the issuance of the debentures and the "purchase price" of the debentures upon their "acquisition" from ITT. The Tax Court held that the ITT's subsidiaries' "purchase price" of the debentures, under the authority of Reg. § 1.1502-41A, was equal to ITT's basis in the debentures, which, as stated above, the Tax Court held was equal to the fair market value of the ITT stock that ITT gave to the debenture holders in exchange for the debentures. The Tax Court's supplemental opinion, at 77 T.C. 1367, made a finding as to the issuance price of the debentures, thereby allowing for the measurement of the ITT subsidiaries' losses.¹

The government argued before both the district court and the Tax Court that the conversion of the debentures and their subsequent transfer by ITT to its subsidiaries effected capital contributions from ITT to its subsidiaries and, therefore, ITT did not realize any losses. The government had also argued before both courts (although the argument was only raised by the Commissioner before the Tax Court on its motion to reopen the

¹ It should be noted that ITT argued in the Tax Court case that either ITT or its subsidiaries recognized losses upon the transfer of the debentures from ITT to its subsidiaries, whereas in the district court case, ITT argued that only ITT recognized losses upon the transfer of the debentures from it to its subsidiaries. In the instant case, there can be no issue as to the debtor subsidiary's losses because the subsidiary, [REDACTED], is a foreign entity.

case and was not addressed by the court) that the debentures did not survive the conversion and, therefore, the ITT subsidiaries had no basis in the debentures upon their transfer to the ITT subsidiaries.

As stated above, the district court held that the parties were bound by the earlier Tax Court opinion as to the measurement of basis of the debentures in the hands of ITT; i.e., that basis in the debentures is equal to the value of the stock ITT exchanged for the debentures upon conversion. However, the district court also held that the Tax Court had not addressed the issue of whether the debentures survived the conversion but instead relied on the parties stipulation that the debentures had, in fact, survived. No such stipulation existed in the district court case. Thus, the district court held that the government was not collaterally estopped from arguing that no basis, in fact, existed in the debentures by reason of the fact that the debentures did not survive the conversion. The district court stated: "The method of calculation of the basis is not dependent upon the existence of a basis. Thus, if there is a basis in the debentures now before the Court, the Court is bound by the calculation of that basis indicated by the Tax Court." Id. at p. 83,785.

The district court went on to hold that ITT did not have a basis in the debentures (in effect, that the debentures did not remain outstanding after the conversion) and, therefore, ITT did not realize or recognize any losses from the transfer of the debentures back to its subsidiaries. The district court compared the facts of its case, which involved three parties--the subsidiary/debentures issuer, the debenture holders and the parent/stock issuer--to a two party situation in which a single corporation issues the debentures and then issues its own stock to the debenture holders upon the conversion. The district court noted that in the latter case, the law is well settled that the debentures/stock issuer does not realize a loss upon the conversion.

The rationale for this rule (with respect to a single debentures/stock issuer) is that any difference between the face amount of the debentures and the fair market value of the stock received in exchange upon conversion is an element built into the debentures from the time of their issuance for which the issuer cannot claim a deduction. Specifically, the convertible debentures contain a dormant equity obligation from the beginning and any rise or fall in the fair market value of the issuer's equity between the time the debentures are issued and the conversion date should not be recognized just like any rise or fall in the fair market value of stock between the date it is issued and the date it is subsequently repurchased cannot be recognized.

In other words, a convertible debenture is an indivisible unit and the issuer has but one obligation. The obligation is satisfied either by converting the debentures into equity or by redeeming the debentures. The issuer can never be required to do both. When the conversion option is exercised, the debentures turn into a purely equity obligation and the debt obligation features completely disappear. Thus, the issuer does not retain a basis in the debentures after their conversion. See National Can Corporation v. United States, 687 F.2d 1107, 1114-1115 (7th Cir. 1982) (quoted below); aff'g 520 F. Supp. 567 (N.D. Ill. 1981); Chock Full O'Nuts Corporation v. United States, 453, F.2d 300, 304 (2d Cir. 1971), aff'g 322 F. Supp. 722 (S.D. N.Y. 1971); Husky Oil Company v. Commissioner, 83 T.C. 717, 735 (1984); Honeywell, Inc. v. Commissioner, 87 T.C. 624, 639-642 (1986).

The underlying rationale for the rule that a corporation cannot recognize a loss upon the repurchase of its own stock is that the issuance and repurchase of a corporation's stock is purely a transaction involving the capital structure of the corporation with respect to which there is never any economic gain or loss to the corporation. Specifically, any amount paid by the corporation for its own stock is merely the return of the shareholders' equity contributions, plus or minus any economic gain or loss realized by the corporation subsequent to the contributions. This gain or loss is reflected in the fair market value of the stock and the amount paid by the corporation upon repurchase of the stock. In other words, the corporation's repurchase of its stock is not a transaction entered into for profit but merely the return of the shareholders' investment plus or minus any appreciation or depreciation in the investment. See Stokely-Van Camp v. United States, 21 Cl. Ct. 731 (1990) (and cases cited therein); McCrory Corporation v. United States, 651 F.2d 828 (2d Cir. 1981) (and cases cited therein).

At the shareholder level, any gain or loss realized by the corporation and subsequently returned to the shareholders is recorded by the shareholders as a return of, or on, their investment or as a loss of, or on, their investment. See sections 301 and 302. At the corporate level, Congress' stated policy of having two levels of taxation with respect to corporations means that any gain or loss realized by the corporation subsequent to the shareholders contributions would have normally already been reported either as income or as a deduction by the corporation. Thus, any additional recognition of gain or loss by the corporation upon the repurchase of its

stock would be a double inclusion of income or double deduction at the corporate level.²

The point is that a corporation's satisfaction of its equity obligation upon the conversion of convertible debentures is comparable to a corporation's repurchase of its own stock. The district court in ITT held that the same rationale should apply in a three party situation. In other words, in a three party situation, the subsidiary/debenture issuer and the parent/stock issuer are treated under a single entity approach. In so holding, the district court in ITT relied on National Can.

In National Can, the taxpayer, a parent corporation, exchanged its stock for debentures which had previously been issued by its subsidiary. The fair market value of the stock exchanged was substantially higher than the face value of the debentures received. Unlike the ITT cases, the parent corporation/taxpayer in National Can held onto the debentures it received in exchange for its stock and received interest income from its subsidiary on the debentures. The court disallowed the taxpayer's effort to have the difference between the value of the stock issued and the debentures received recognized as a loss.³ The Seventh Circuit concluded: "[T]he rule is already well established that a corporation realizes no gain or loss when it issues stock in satisfaction of a conversion obligation of its own bonds. There is no reason that the use of a subsidiary should make any difference." Id. at 1116.

The Seventh Circuit, in National Can, relied on a several related theories for its holding, the essence of which was relied upon by the district court in ITT, as outlined above. The Seventh Circuit's discussion of this rationale is contained in its discussion of sections 171 and 249. The taxpayer, in National Can, argued that the "premium" paid by the parent corporation by its issuance of its stock in exchange for the

² Note that the current version of section 311 ensures that almost any gain from appreciated property is recognized by the corporation before its distribution to shareholders.

³ In National Can, the parent corporation/stock issuer attempted to recognize a loss upon the conversion, whereas in the ITT cases, the taxpayers did not claim that ITT (the parent corporation/stock issuer) recognized losses upon the conversion but rather only recognized losses upon the subsequent transfers of the debentures from ITT to its subsidiaries. Similarly, the petitioners in this case do not claim [REDACTED] (the parent corporation/stock issuer) recognized losses upon the conversion but rather that [REDACTED] recognized losses upon its subsequent transfers of the debentures.

debentures was amortizable bond premium deductible under section 171. The Seventh Circuit stated that the bond premium envisioned by Congress as amortizable under section 171 is attributable to a fall in market interest rates which causes the purchaser of the bond to pay more for the bond. Id. at _____. The Seventh Circuit stated that, in the case of a convertible debenture, any "premium" paid by the issuer or its parent in the form of stock upon the conversion is not attributable to a change in market interest but to a change in the fair market value of the stock and, thus, section 171 would not apply to such a "premium."

Furthermore, the Seventh Circuit noted that this same dichotomy--between a change in market interest rates and a change in the value of the issuer's stock--was recognized by Congress when it enacted section 249. Section 249 holds that no deduction is allowed for any premium an issuer pays to repurchase debentures convertible into the issuer's stock or the stock of a corporation controlled by the issuer. This provision did not literally apply to the facts in National Can (and it does not apply to the facts here) because the alleged "purchaser" of the debentures was (is) the issuer's parent. However, the Seventh Circuit noted that Congress' rationale for enacting section 249 applied equally as well to the facts of its case. (And, it applies equally as well to the facts of this case.) As explained by the Seventh Circuit:

However, the Section [249] again illustrates the line Congress has consistently drawn between bond premiums attributable to the interest cost of borrowing and the bond premium attributable to a conversion privilege. As Congress reasoned in passing Section 249, premium due to a conversion feature is "not analogous to an interest expense or deductible business expense, but rather is similar to an amount paid in a capital transaction. In effect, the corporation is repurchasing the right to convert the bonds into its common stock much as it might purchase its stock." H.R. Rep. No. 413, 91st Cong., 1st Sess. 111, reprinted in 1969 U.S. Code Cong. & Ad. News 1645, 1759-1760; see also Chock Full O' Nuts Corp. v. United States, 453 F.2d 300, 306 n. 19 (2d Cir. 1971). Here Can's [the parent/taxpayer's] transaction did not merely remove from the market the right to enter into a future capital transaction--the evil for which Section 249 disallows any deduction--but involved a present substitution of capital-stock liability for its subsidiary's bonded indebtedness. See Cary, supra, 74 Harv. L. Rev. at 497. Thus, the Congressional purpose of disallowing deductions for premiums attributable to essentially capital transactions encompasses the transactions here,

Id. at _____. The point is that when either the subsidiary or its parent satisfies its equity obligation upon the conversion of the debentures by issuing its stock, the transaction is an equity transaction, exactly like when a corporation purchases its own stock, and no gain or loss is realized or can be recognized.

The bottom line of both the ITT district court case and the National Can case is that any rise or fall in the fair market value of the stock issued in exchange for the debentures cannot be recognized by the parent corporation/stock issuer upon either the conversion, itself, or upon any subsequent disposition of the so called converted debentures. This conclusion applies in this case as well. The alleged losses resulting from the rise in the fair market value of [REDACTED]'s stock between the date the debentures were issued and the dates of the conversions cannot be recognized upon either the conversion, itself, or upon the subsequent disposition of the debentures by [REDACTED].

The district court's opinion in ITT and the Seventh Circuit's opinion in National Can is in conflict with the Tax Court's opinion in ITT. As stated above, the Tax Court, in ITT, held that ITT's basis in the debentures at issue was equal to the value of the stock ITT exchanged for the debentures upon conversion. This holding lead to the recognition of losses by the ITT subsidiaries in that case. However, the district court held in its ITT case that ITT did not have a basis in the debentures and arguably the Seventh Circuit opinion can be read as holding that the parent/stock issuer in its case did not have a basis in the debentures either. At the very least, both the district court in ITT and the Seventh Circuit in National Can held that the alleged losses resulting from the rise in the fair market value of parent/stock issuer's stock between the date the debentures were issued and the dates of the conversions is not recognizable, whereas the Tax Court allowed the same alleged loss to be recognized in its ITT case.

As stated above, the Tax Court in its ITT case relied on section 1012 and Reg. § 1.1032-1(d) for its holding. We concede that generally the basis of property received in exchange for its stock is the value of the stock if a nonrecognition provision does not apply. However, sections 1012 and 1032 should not have been applied without qualification in that case. ITT's actual cost basis in the debentures was not the fair market value of the ITT stock issued in exchange but the face amount of the debentures. The difference was a capital contribution from ITT to its subsidiaries. This must be so because it reflects the fact that ITT assumed its subsidiary's obligations which is an equity obligation at the point the holder exercises his conversion right.

Although the capital contribution analysis was not discussed by the district court in ITT or the Seventh Circuit in National Can, it is consistent with the court's analysis and, in fact, we believe it is implicitly present because, again, there is no other way to explain the parent/stock issuer's assumption of the contingent equity obligation in those cases. If it is argued that upon the conversion of the debentures, the debentures cease to exist, which is arguably the district court's holding in ITT, ITT's assumption of the equity obligation must be accounted for somehow. The only way to explain it is by means of a capital contribution.⁴

Thus, the Tax Court in ITT has failed to take into account the substance of the transaction at issue and its corresponding tax consequences and, therefore, the court's holding as to ITT's basis in the debentures is erroneous.

In conclusion and based on the above analysis, we believe that [redacted] made a capital contribution to [redacted] measured as the difference between the fair market value of the [redacted] stock that [redacted] gave the debenture holders and the \$[redacted] worth of indentures it received (or retained) in exchange: i.e., \$[redacted]. The \$[redacted] is the net cost to [redacted] of assuming the equity obligation for its subsidiary, [redacted]. And, \$[redacted] is the economic benefit to [redacted] of [redacted]'s assumption of the equity obligation. As shown above, the only way this can be explained is by the parent-subsidary relationship between [redacted] and [redacted]. The only way this economic benefit can be transferred from [redacted] to [redacted] is by a capital contribution.

The consequence of this analysis is that [redacted]'s basis in the debentures is not \$[redacted] but \$[redacted]. Because the difference between these two figures was a capital contribution by [redacted] to [redacted], the difference cannot be added to the basis of the debentures received by [redacted], or if the debentures are treated

⁴ If it is argued that the debentures, in effect, cease to exist upon conversion, [redacted] would be deemed to have issued "new" debentures to [redacted] with a face amount of \$[redacted]. See the attached memorandums, dated November 18, 1987 and December 3, 1987, for various ways the transactions at issue can be characterized to show that [redacted] is making a capital contribution to [redacted]. Our preferred conceptualization is to argue that, in effect, "new" debentures are issued by [redacted] as the consideration given by [redacted] to [redacted] for assuming its convertible debenture obligation. Also included in the memorandums is a conceptualization that assumes that the debentures remain in existence after the conversion; so called "converted" debentures.

as "new" debentures (see attached memorandum), this amount would not be part of the basis of the "new" debentures. Accordingly, when the debentures were later dropped down to [REDACTED] and disposed of, [REDACTED]'s basis in the debentures would have also been \$ [REDACTED]. Because the debentures were disposed of by [REDACTED] for an aggregate amount of \$ [REDACTED], [REDACTED] did not realize or recognize any losses upon the disposition of the debentures.

Based on the above analysis, we also believe LTR 81-081-04 (November 26, 1980), which is cited by the taxpayers to support their position, is an incorrect statement of the law. The letter ruling is in conflict with the Seventh Circuit's opinion in National Can and the district court's opinion in ITT. Furthermore, the letter ruling cannot be relied upon by the taxpayers as Service position or as precedent. Currently, we are in contact with Technical in attempt to have the letter ruling revoked.

Finally, it should be noted that in Rev. Rul. 85-163, 1985-2 C.B. 349, the Service stated that it would not apply Rev. Rul. 84-152, 1984-2 C.B. 381, and Rev. Rul. 84-153, 1984-2 C.B. 383, to interest payments made in connection with indebtedness issued by Netherlands Antilles corporations before October 15, 1984. Rev. Rul. 84-152 and Rev. Rul. 84-153 held that indebtedness issued by Netherlands Antilles corporations merely to obtain financing that was immediately reloaned to domestic affiliates would be treated as indebtedness issued by the domestic affiliates. The effect of Rev. Rul. 85-163 is that the Service will not make such an argument with respect to such indebtedness issued by Netherlands Antilles corporations prior to October 14, 1984. See also GCM 39,452, CC:I-051-85 (May 30, 1985) (note that we disagree with the specific holding in GCM 39,452, although the GCM states the rationale for not treating indebtedness issued by a Netherlands Antilles corporation as the indebtedness of its domestic affiliates). The effect of Rev. Rul. 85-163 in this case is that we cannot make the argument, proposed by the examiner, that the convertible debentures issued by [REDACTED] were, in substance, issued by [REDACTED].

II. Issue 2:

Section 61(a)(12) states that gross income includes income from a discharge of indebtedness. Treas. Reg. § 1.61-12(a) states in part: "In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt." Section 108(e)(6) states: "For purposes of determining income of the debtor from discharge of indebtedness, if a debtor corporation acquires its indebtedness from a shareholder as a

contribution to capital--(A) section 118 shall not apply, but (B) such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in the indebtedness." The Senate Finance Committee Report to section 108(e)(6), which was enacted as part of the Bankruptcy Tax Act of 1980, states:

Whether a cancellation of indebtedness by a shareholder-creditor is a contribution of capital depends upon the facts of the particular case. In order for the contribution to capital rule to apply, the shareholder's action in cancelling the debt must be related to his status as a shareholder. If the shareholder-creditor acts merely as a creditor attempting to maximize the satisfaction of a claim, such as where the stock and bonds are publicly held and the creditor simply happens also to be a shareholder, the cancellation of the indebtedness on exchange of the bonds for stock is not to be treated as a contribution to capital by a shareholder for purposes of this rule.

S. Rep. No. 1035, 96th Cong., 2d Sess. 1, 19 n. 22, 1980-2 C.B. .

Section 301(b)(1)(B) states that the amount of any distribution of property to a corporate shareholder is the lesser of the property's fair market value or the basis of the property in the hands of the distributing corporation plus any gain recognized by the distributing corporation upon the property's distribution. Section 301(d)(2) states that the same rule applies for determining the basis of the distributed property in the hands of the corporate distributee.

In this context, sections 301(b)(1)(B) and (d)(2) means that if the indebtedness had a fair market value less than the [REDACTED]'s basis in the indebtedness (i.e., a fair market value less than the \$[REDACTED] of the indebtedness that remained outstanding) at the time of its distribution to [REDACTED], [REDACTED] would take a basis in the indebtedness equal to its fair market value. This basis would then carryover to [REDACTED] upon [REDACTED]'s contribution of the indebtedness to [REDACTED]. Arguably, upon [REDACTED] contribution of the indebtedness to [REDACTED], [REDACTED] would then recognize discharge of indebtedness income, under section 108(e)(6), equal to the difference between [REDACTED]' basis in the indebtedness and the remaining amount of the outstanding indebtedness.

However, there is no indication that the indebtedness had a fair market value less than [REDACTED]'s basis in the indebtedness at the time of its distribution to [REDACTED] and, thus, [REDACTED] would take a basis in the indebtedness equal to [REDACTED]'s basis in the indebtedness (i.e., a basis equal to the remaining outstanding indebtedness at the time of the distribution). [REDACTED] would

take a carryover basis in the indebtedness. Upon [REDACTED] contribution of the indebtedness to [REDACTED], the basis of the indebtedness in [REDACTED] hands would equal the remaining amount of the outstanding indebtedness and [REDACTED] would not recognize discharge of indebtedness income under section 108(e)(6).

Furthermore, because there is no indication that the indebtedness between [REDACTED] and [REDACTED] was not bona fide--in fact, the examiner in this case asserts that there was ample evidence to indicate that the indebtedness was bona fide--we see no reason to stray from the well established rule that a contribution of a debt from a shareholder-creditor to a corporation-debtor in which he is a shareholder generally does not result in discharge of indebtedness to the corporation-debtor. The evidence indicates that [REDACTED] distributed the debt to [REDACTED], which in turn contributed it to [REDACTED], which in turn contributed it to [REDACTED]. All of these transactions were perfectly valid. Just because the transactions had some beneficial tax implications for the group, as asserted by the examiner, does not somehow change the general rule. Therefore, assuming that the basis of the indebtedness in the hands of [REDACTED] was at least equal to the remaining amount of the outstanding indebtedness at the time [REDACTED] contributed the indebtedness to [REDACTED], [REDACTED] did not realize discharge of indebtedness income.

Please note that we have only examined these transactions to determine whether [REDACTED] realized discharge of indebtedness income. We express no opinion as to any other tax implications with respect to the transactions at issue.

RECOMMENDATION

Issue 1:

For the reasons outlined above, [REDACTED] did not realize and cannot recognize any losses on the disposition of the debentures at issue. Therefore, we recommend pursuing this issue.

Issue 2:


Assuming that the basis of the indebtedness in the hands of [REDACTED] was at least equal to the remaining amount of the outstanding indebtedness at the time [REDACTED] contributed the indebtedness to [REDACTED], [REDACTED] did not realize discharge of indebtedness income in the circumstances at issue. Therefore, we recommend conceding this issue.

- 18 -

If you have any questions, please contact Lawrence S. Mannix
at FTS 566-3470.

MARLENE GROSS

By:


STEVEN J. HANKIN
Senior Technician Reviewer
Branch 2
Tax Litigation Division

Attachments:
As stated